PHILIP ANGELIDES
Treasurer
State of California

June 1999

HONORABLE GRAY DAVIS
Governor

HONORABLE JOHN L. BURTON
President pro Tempore of the Senate

HONORABLE ANTONIO VILLARAIGOSA
Speaker of the Assembly

I am hereby transmitting for your consideration, **Smart Investments**, a special update of California's Debt Affordability Report.

The statutorily required Debt Affordability Report is submitted annually to provide an analysis of the State's debt position and debt capacity – a look at how much the State can afford to borrow for infra-structure investment. This report is designed to assist the Governor and the Legislature in their capital planning and financing decisions. This special update is being provided to make a timely contribution to the current deliberations on the vital matter of public investment in California's future.

More than at any time in our recent history, public and private sector leaders and members of the general public are confronting the reality that California's future success is dependent on our willingness to make smart investments in the public fabric that will sustain both economic growth and favorable living conditions.

The State Treasurer is responsible for advising the Governor and the Legislature on how much debt the State can afford to issue for infrastructure investment. As the State's fiscal and investment officer, the Treasurer has an obligation to advocate for the most prudent, effective and efficient use of precious financial resources. Further, the Treasurer's Office has a responsibility to make recommendations with respect to debt capacity and infrastructure investments that best assure our long term economic viability.

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Our future economic strength, and the State's fiscal stability, are in no small part dependent on the continued attractiveness of California not only as a place to *locate business*, but also as a good place to *work* and *live*. Growth patterns that accelerate environmental degradation and exacerbate the widening gap in economic opportunity among our residents threaten California's future success.

It is clear that California must plan now for the dramatic growth projected to occur in the years ahead and must make the investments needed to accommodate that growth. The State's intelligent investment of its public resources in a manner that supports environmentally respectful, well-planned growth and promotes equality of opportunity is vital to our sustained economic progress.

Accordingly, this report goes beyond simply providing an updated fiscal analysis; it urges a new approach, **Smart Investments**, which recognizes that how we spend precious dollars and the approaches we take to capital investment can shape the vibrancy of California into the 21st Century.

The dialogue about how California meets the public investment challenges of the 21st Century is just beginning. The policy recommendations contained in this report are by no means meant to be fully comprehensive. Rather, they should be viewed as important foundational principles for discussion by the Governor, the Legislature, the Governor's Commission on Building for the 21st Century, and the other public and private sector groups seeking to create smart investment policies and planning processes.

This report represents only a first step by this office to contribute to this important debate. We plan to bring forth, in the months ahead, additional recommendations for consideration, including proposals for cost-effective financing strategies to meet the State's investment goals.

I look forward to assisting in this critical endeavor so that together, we can secure a livable, economically vibrant California.

Sincerely,

P H I L I P A N G E L I D E S
State Treasurer

cc: Honorable members, California Legislature

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EXECUTIVE SUMMARY

During the next 20 years, California will add more than five million new jobs. This economic growth will be accompanied by more than 12 million new residents, over four million new households, and upwards of two million new schoolchildren. The projected growth of the next 20 years will equal that experienced in the boom years of the 1950s, 1960s, and 1970s combined. Perhaps even more astounding, it will surpass the growth California saw during its first *century* of statehood.

This projected growth will pose the most dramatic challenge for California's leaders since California became a state. It will increase the need for all forms of public and private sector goods and services – needs that will overwhelm public resources if investment policies are not conceived with wisdom and vision. These needs will include – but by no means be limited to – quality schools, parks and public open spaces, and the provision of adequate, cost-efficient systems of water, electricity, and transportation. This surge in jobs and population not only will create the need for new investments, it also will place added stress on an already overburdened and deteriorating physical infrastructure.

It is clear that California must plan now for the dramatic growth projected to occur in the years ahead and must make the investments needed to accommodate that growth. Decades of under-investment have worn thin our public fabric. Apart from the demand created by new growth, we must invest to improve our current quality of life – reducing public school class size, enhancing our mobility, and restoring our parks and community facilities – even as we plan to meet the needs of expected future growth.

Sustained economic success in the 21st Century will require the investment of public resources to ensure the continued attractiveness of California as a place not only to locate business, but also as a good place for people to work and live. Implicit in these investment objectives is the recognition that California will not achieve economic success in the long run if our environment is degraded or if there are pockets of economic failure throughout our State.

It is clear that the challenge for policy makers is not whether California will grow, but rather, *how we will grow and how investment policy can support growth patterns which bolster the State's economic, environmental, and social progress.*

At this critical juncture, it is particularly important to examine anew the most productive, innovative, and cost-efficient means of investing precious public capital to support sustainable growth patterns which best ensure long-term economic success.

This special update of the Debt Affordability Report – **Smart Investments** – examines the State's capacity to incur debt to finance infrastructure investments and makes a set of recommendations to help guide the dialogue on how the State can best invest to secure California's economic future.

This report makes the following findings and recommendations:

California has significant debt capacity, but lacks an investment plan.

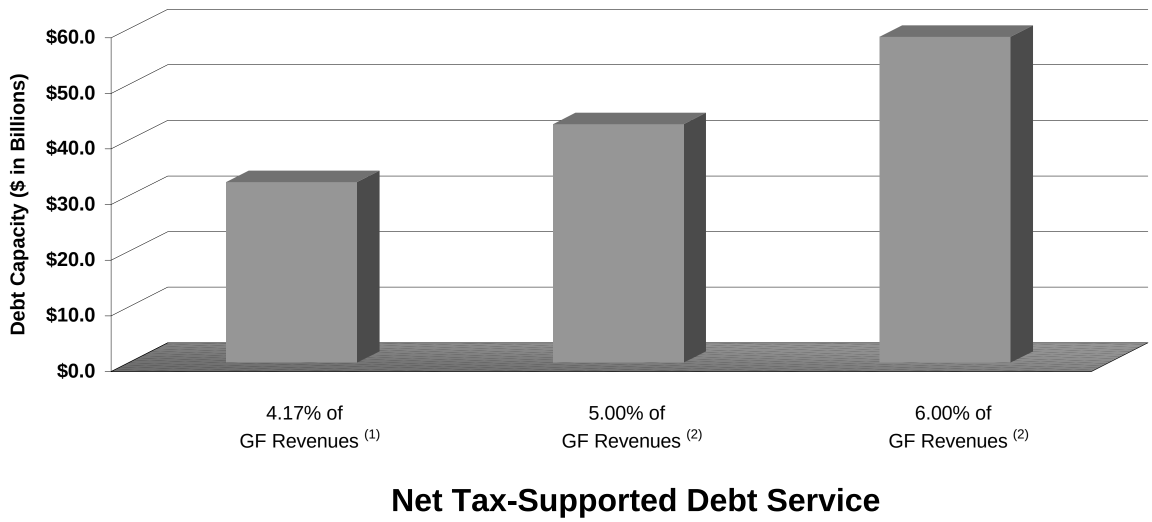
- The State's projected General Fund debt capacity is approximately $32.5 billion over the next ten years, based on the current revenue projections and budget structure. This amount includes $14.7 billion in bonds already authorized but not yet issued. Depending on revenue projections over the next decade, the total General Fund debt capacity could range from as low as $27.5 billion to as much as $38 billion.

  The current proposed State Budget (Governor's May 1999 Revision) allocates 4.17 percent of General Fund revenues to debt service. The debt capacity projected in this report is based on the State retaining this level of commitment to debt service. Maintaining the current 4.17 percent will require expenditure containment consistent with revenue growth. Increasing the percentage committed to debt financing will require either new revenues, revenue growth which outpaces expenditure increases, or reductions in other program expenditure levels.

  If the State gradually increased the ratio of debt to General Fund revenues to 5 percent over the next five years, debt capacity would increase by approximately $10 billion to $42.9 billion over the next ten years. If the State increased this ratio to 6 percent over the same period, the debt capacity would reach $58.6 billion over the next ten years. Debt capacity analysis, by its nature, cannot factor in unexpected spikes in revenues since debt must be issued against a reasonably stable flow of revenues.

  Therefore, more funding for infrastructure investment beyond debt capacity may be available on a "pay as you go basis" from such one-time revenue increases. The State should give high priority – as the Governor proposed in his May 1999 budget revision — to using such surpluses for infrastructure investment, given the substantial investment needs of the State and given the desirability of not committing funds available on a one-time basis to long-term obligations. The State's General Fund debt capacity is in addition to the $35.6 billion identified by the Department of Finance as available for infrastructure investment from other funding sources, including the State's "pay as you go" programs, over the next ten years. These combined resources most likely will fall short of expected needs. However, current needs assessments are not based on a comprehensive plan of investment nor are they centered around achieving the goals of sustained economic growth, environmental preservation, equality of opportunity, and livability. Rather, they represent a list of projects compiled independently by various public agencies.

Ten-Year Debt Capacity at Alternative Levels of Debt Service to General Fund Revenues



[1] Based on FY 199-00 General Fund Budget [2] Assumes gradual increase to this level by FY 2004-05

While our infrastructure needs will almost certainly exceed currently identified funding and debt capacity, California must first adopt visionary investment principles and strategies for the wise use of precious capital, rather than focusing solely on additional dollars needed for an undefined task.

Economic growth principles, not "magic" budget percentages or project "laundry lists," should drive investment policy.

- California must clearly make a commitment to invest as needed to ensure the State's continued economic vibrancy. Yet, good investment policy dictates that the nature and exact level of public investment should be driven by a set of principles guiding California's future economic growth, not by a "magic" percentage of the State's budget or a laundry list of capital projects desired by various agencies.

  To date, much of the discussion surrounding infrastructure investment has revolved around dollar needs versus dollar availability, in the absence of a strategic investment plan. No successful, dynamic company would begin its investment planning without first asking fundamental questions: Where do we want to be in the 21st Century? What do we want to look like in the years ahead? What are the best investments to achieve our goals? What are the most cost-effective ways of making those investments? What processes and structures will get us there?

  California needs to ask these questions and more. The answers to these questions should drive the nature, direction, and amount of our investments. The postwar generation of Californians looked ahead and made investments that strengthened this State for decades. The State invested in a public fabric – a great university system, a state of the art transportation network, remarkable water projects – that was the foundation for economic expansion. The next wave of investment should be designed with the vision to meet the vastly changing needs of the next 50 years – and should not be a mere replication of the types of facilities that were built to serve Californians for the last 50 years.

  This new age of investment must support growth principles that best ensure the State's long term economic strength, environmental quality, and equality of opportunity.

A key principle: Investments that support livable communities, sustainable development, and sound environmental practices strengthen the economy.

- California's long-term economic health depends, in part, on a change in our growth patterns – to new forms of more sustainable development at the urban fringe, and to renewed economic growth and investment in existing communities, many of which have been left behind in the California economy. Infrastructure investments are a critical determinant of growth patterns, and therefore must support these goals.

  Present growth trends and practices are eroding our economic competitiveness and environmental quality, just as blind resistance to growth will create chaotic results and impede economic progress. The sheer magnitude of the State's job and population increases will require that new growth be accommodated in more thoughtful ways both at the urban perimeter and within the existing urban fabric. Stronger regional planning and state infrastructure investment consistent with such planning are required to foster these new growth goals.

Sustainable development means land uses that support transportation options beyond more freeways and roads; a better mix of housing in communities and neighborhoods; locating jobs near housing and balancing job growth with new housing; communities centered around civic spaces with features such as tree-lined streets and "human scale" design; more efficient, well planned higher-density use of land; and protection of environmental resources.

California's economic attractiveness has been and will always be integrally tied to the State's livability and environmental quality. Our infrastructure investments and growth patterns must recognize this reality.

Re-investment in declining communities is essential to reverse a dangerous trend toward "two Californias," one in poverty and the other enjoying an economic boom.

- California as a whole cannot succeed economically if there are two Californias – with most of the State experiencing a buoyant economy while simultaneously there are pockets of the State in economic decline and devastation. Present land use and growth patterns reflect the growing separation of these two Californias.

  A two-tiered California poses a number of threats to long-term economic success. Educational failure will damage the quality of our workforce. Poverty will increase the fiscal burden on the State and local governments. Fears for public safety will negatively affect private sector investment decisions. Most importantly, the very essence of the California dream – equality of opportunity – will be lost.

  Investments should be directed to support communities at risk or in decline, which in turn would advance the goals of more sustainable development and reduced growth pressures at the urban perimeter.

  The predicament of poorer, established neighborhoods has been exacerbated by the lack of consistent public investment throughout California in the past three decades and by growth patterns that have discarded neighborhoods in 25-year cycles. Although economic resurgence of such neighborhoods will require multi-faceted public policy attention, infrastructure investment is an important tool of revitalization.

Smart investment policy requires a new focus on cost-effectiveness, return on investment, and results to sustain California's economic growth.

- Every dollar invested in support of the goals of sustainable economic growth and community reinvestment must be viewed as a precious resource. Under any analysis, the State's investment needs are enormous. Therefore, hard questions must be asked of any investment proposal, as they would be asked by any successful corporate entity considering strategic expenditures:

- Is the investment proposal consistent with growth principles that best ensure California's long-term economic, environmental, and social strength?
- Is it the most cost-effective means of achieving the desired result?
- Will it provide an adequate return on investment?
- Will it protect or enhance already existing assets?

This approach entails a move away from simply building more conventional facilities and demands a smarter fiscal approach that looks at cost-effective alternatives. For example, a smart investment plan should consider how reallocation of water rights and conservation of water lessens the need for new water facilities; how community, library and educational facility needs can be met more cost-effectively through joint use efforts; how community mental health programs, substance abuse treatment, and youth employment opportunities could reduce the need for new prisons; and how the State can continue to meet its energy needs, as it has in the recent past, through innovative approaches such as demand management, competition, and new technology.

New avenues may not always be the easiest to explore inasmuch as they may challenge the existing orthodoxy and political status quo. Yet, the prudent stewardship of public resources demands such examination and exploration.

Smart, cost-effective investing represents a new discipline for the public sector and also requires an understanding of which public goods and services best contribute to private economic expansion. Therefore, the strategic investment process needs to actively engage California's dynamic private sector and needs to be built on a foundation of long-range economic analysis.

The State's investment plan must rely on strong regional planning to meet its objectives.

- California needs a *comprehensive* state capital planning process to evaluate, scrutinize, and prioritize the investments needed to achieve the State's economic growth objectives.

  The need for such a rational capital outlay process has been widely and properly recognized by a variety of public and private sector organizations.

  In establishing such a process, it is critical to acknowledge that strong regional planning is elemental to achieving sustainable growth and community reinvestment goals. Issues such as affordable housing, jobs and housing balance, open space preservation, and transportation transcend traditional city and county boundaries.

  Accordingly, any state capital outlay financing process must include a strong regional planning component, with state infrastructure investments made in accordance with and in support of credible regional plans which foster the State's growth principles. Further, regions must be empowered to better finance investments of regional significance.

Communities need majority vote approval for local capital investments.

- Although the State takes the lead in investments of statewide significance, it is clear that investment needs cannot be met by the State alone. As noted above, any successful investment plan must recognize the importance of regional solutions. And, any meaningful strategy must free up California communities to make investments that contribute to their own efforts to sustain economic growth, protect the environment, enhance quality of life, and provide opportunity to struggling neighborhoods. California is too large for a single statewide approach.

  To that end, communities should have the right, by majority vote, to make capital investments in schools, parks, and other critical community improvements. This is particularly important for existing, established neighborhoods that cannot rely on growth-related fees and revenues. While other reforms to local financing are needed, a majority vote threshold supports the goal of stabilizing existing, at risk communities and recognizes that local communities are best positioned to make decisions about neighborhood needs. Local empowerment also recognizes that an already strained state budget cannot adequately finance local needs.

  California faces critical choices as to how it invests to build and sustain its economy while simultaneously contributing to the quality of life and equity of opportunity of its inhabitants well into the 21st Century.

The Treasurer's Office stands ready to work with the Governor, the Legislature, the Governor's Commission on Building for the 21st Century, and the people of California as we embark on a new era of investment in our future.

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